# Guide to Commercial Real Estate Investing Utilizing Delaware Statutory Trusts (DST)

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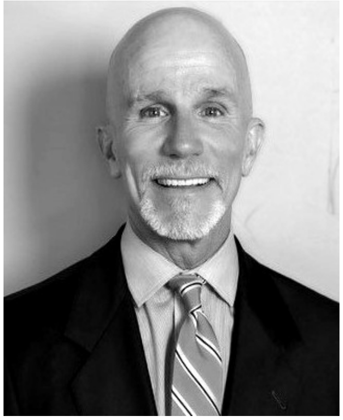
- There is no guarantee that any strategy will be successful or achieve investment objectives;
- Potential for property value loss – All real estate investments have the potential to lose value during the life of the investments;
- Change of tax status – The income stream and depreciation schedule for any investment property may affect the property owner's income bracket and/or tax status. An unfavorable tax ruling may cancel deferral of capital gains and result in immediate tax liabilities;
- Potential for foreclosure – All financed real estate investments have potential for foreclosure;
- Illiquidity – Because 1031 exchanges are commonly offered through private placement offerings and are illiquid securities. There is no secondary market for these investments.
- Reduction or Elimination of Monthly Cash Flow Distributions – Like any investment in real estate, if a property unexpectedly loses tenants or sustains substantial damage, there is potential for suspension of cash flow distributions;
- Impact of fees/expenses – Costs associated with the transaction may impact investors' returns and may outweigh the tax benefits



Tom Straw

Welcome.

Thank you for taking the time to learn about reinvesting the cash proceeds from your 1031 Exchange into a portfolio of Delaware Statutory Trust (DST) investment offerings.

I created this guide to give you a broad understanding of commercial real estate and help you thoughtfully construct a diversified portfolio of DST investments that fits with your overall retirement plan.

During the past decade, commercial real estate has become an increasingly accessible asset class for the individual taxable investor. In the past, commercial real estate was always reserved for institutional investors and wealthy families in "club" deals.

Looking back, the active investments you made in single-family homes, short-term rentals and small multi-family properties was an established way to create personal wealth. Balancing your career and family demands all while shouldering the duties of being a landlord has paid off.

But now, you are exploring the transition to the next phase of your life. If you want to retire your landlord responsibilities, while striving to preserve the monthly income those active investment properties generate, a portfolio of DST investments might be an option.

The good news – those underwriting skills you learned while actively investing in residential real estate share many similarities to passively investing in professionally managed commercial real estate offerings.

However, the variety of asset types and magnitude of the U.S. commercial real estate market dwarfs the local residential real estate market in which you were operating.

Portfolio diversification and asset allocation are the most strategic decisions any investor will make when investing in stocks or bonds – real estate is no different.

Today, advancements in reporting and accounting software allow institutional real estate operators to offer individuals relatively low minimum investment requirements and best-in-class investor relations. The result – individuals can now construct a properly diversified real estate investment portfolio that has the potential to generate passive monthly income to replace their active investment property income.

The current DST market is expanding and attracting real estate operators across an array of asset classes, geographic regions and risk/return profiles. This environment offers an efficient market for 1031 Exchange investors to meet the IRS's 180-day timeline while having the time to thoughtfully construct a diversified DST investment portfolio.

After reviewing the guide, please contact me if you have questions. I can help you navigate the nuances of the commercial real estate market, but the investing part is up to you.

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## Making the Transition from Residential to Commercial Real Estate Investing

The typical first step for individuals investing in real estate is the asset class referred to as single-family residential or SFR. Most often, prospective SFR investors own the house they live in (known as a Primary Residence), which gave them the experience of purchasing, maintaining and possibly renovating a SFR property.

So, the logical next step is acquiring a SFR for investment and renovation with the intent of either renting or selling this SFR.  Maybe next, the investor acquires a duplex (referred to as Multifamily) with the intent of renovating for rental to tenants. Follow on, maybe the investor acquires a triplex.

This type of hands-on, real estate investing is a proven strategy to potentially generate both current income and long-term wealth.

However, there are challenges and risks specific to investing in local market, multi-family or SFR properties:

- Extremely hands on and time-consuming for an investor and/or third-party property management fees eating away at net operating income (referred to as NOI)
- Unforeseen capital expenditures or catastrophic repairs can wipe-out years of an investor’s cash flow
- Occupancy is binary with the property either rented, or sitting vacant
- Diversification away from local economic cycles and geographic impacts can be unscalable for investors restricted by their ability to travel between markets
- Pricing pressure as the bulk of SFR bidders are seeking a place to call home, removing objectivity from the bidding process and driving up the acquisition price for investors

Investing in commercial real estate does not come without risks and diversification is a core principle of portfolio management.

An investor’s 1031 Exchange allocations should take into consideration that investor’s broader investment portfolio, which might include stocks, bonds, a 401(k) and income from a defined benefit retirement plan.

The decision to invest in 1031 Exchange offerings is portfolio level diversification against an investor’s non-real estate holdings.

To build a diversified portfolio of 1031 Exchange investments requires an understanding of risk categories specific to real estate and allocate across those categories:

- Geography – location risk can be defined two ways. First, what part of the United States is the property located and what non-economic factors might impact the property such as flooding, hurricanes, drought and fires. Second, the state’s tax structure, a pro-business environment or not, and general size of the metropolitan area of the property.  Mixing locations can create diversification.

- Asset Class – local market and broader economic conditions are cyclical with ups and downs that can affect some types of properties more than others. Investing across asset classes can diversify against cyclicality.

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## Making the Transition from Residential to Commercial Real Estate Investing (cont.)

- DST Sponsor – different asset classes require different skills of the sponsors. Factors DST investors should consider when reviewing investment offerings might include the sponsor's historical track record, the team's operating tenure, property management skills and the back-office investor relations reporting. Some sponsors offer investing in a single asset DST and others a portfolio of similar asset types. All good reasons to invest across multiple sponsors.
- Current Income vs. Capital Appreciation – DST investments offer a range of targeted return profiles for investors to select from to create diversification.
    - Capital Appreciation - DST properties for the most part are highly stabilized, with long-term leases in place or multiple tenant structures such as Multifamily or Self Storage. The DST legal structure does not lend itself to major capital improvements which could increase the property's value. Therefore, appreciation in the value of a DST asset from the day of acquisition is often out of the control of the sponsor and more dependent on the general economic conditions of our country at a future point in time when the property is sold.
    - Current Income – DST sponsors reserve the right to suspend monthly investor distributions if the underlying property is not generating enough rental income or NOI to cover the expenses of operating the property. DST investors should position their broader investment portfolio as a cushion to current income should a DST sponsor suspend monthly distributions.
- Loan to Value (LTV) – DST sponsors utilize mortgage debt to finance a portion of the property's acquisition price (referred to as leverage) in their efforts to manage the return profile of their DST offerings. LTV is the ratio of the loan amount divided by the acquisition value of the property. 1031 Exchange investors require a certain LTV ratio to meet the IRS requirements of their 1031 Exchange. The current DST marketplace is robust and offers a range of LTV ratios from All Cash (0% LTV) to highly levered (80% LTV) to meet a 1031 Exchange investor's needs in constructing a well diversified portfolio and satisfying their mortgage debt requirement.

# Overview of the 1031 DST Marketplace

## Investing Utilizing a DST for your 1031 Exchange

A Delaware Statutory Trust (DST) is the legal structure and entity used for real estate investors to defer capital gains tax on the sale of their investment property when making a 1031 Exchange. The net proceeds from the sale of an active investment property can be reinvested in the DST, which qualifies as replacement property under the IRS Tax Code 1031 to satisfy that 1031 Exchange requirement.

The DST ownership structure provides for the fractional ownership by multiple investors in a single property, or a portfolio of like properties, all held within a single DST. Unlike a Limited Partnership (LP) investment, investors in a DST are individual property owners and issued securities for their investment in the Trust. Therefore, each owner receives their percentage share of cash flow income, tax benefits (depreciation) and appreciation, if any, of the property(s).

The DST ownership structure offers investors essentially the same benefits and risks of a direct real estate investment property but leaves all decision-making, and property management responsibilities, to an experienced sponsor-affiliated sole trustee. DST offerings have low minimum investment requirements, which allow 1031 Exchange investors to build a portfolio of commercial properties that otherwise would be out of reach to any single investor.

The DST sponsor has complete discretion over when to sell the real estate property(s) held within the trust. Typically, 10-year mortgage financing is utilized on a DST's real estate holdings. Therefore, DST investors can expect a sale within that 10-year horizon and distribution of their percentage share of the sale's net proceeds, including any appreciation in the value of the real estate property sold.

At that time, those DST investors have three general options:

- An investor may take personal receipt of those proceeds from the sale and prepare to pay the capital gains tax due on the appreciation of the DST's real estate holdings; or,
- An investor may decide to 1031 Exchange those proceeds (or any portion thereof) by reinvesting in any of the DST investment offerings available to them at such time, and all within the 180-day IRS required timeline; or,
- An investor may decide to 1031 Exchange those proceeds (or any portion of) back in active real estate investment property.

DST investment offerings provide no liquidity of an investor's original investment, only the possibility of monthly distributions of cash flow income, until the sale of the real estate property held within the trust. For this reason, investors should take into consideration their overall retirement plan when investing in a portfolio of DST offerings.

## 1031 DST Market Highlights*

The current DST market comprises over 40 sponsors, with the top 6 sponsors garnering almost 70% of the equity being invested by 1031 Exchange investors. Investor inflows during 2021 from 1031 Exchange investors are exceeded $7B in total annual investment.

The DST market is seeing growth in the number of DST sponsors across a variety of asset classes in response to the overwhelming demand by 1031 Exchange investors. Many of the new sponsor entrants are established REIT or Fund management companies with established back offices with experienced investor relations and property teams. Multifamily has been the most popular asset class among sponsors in years past, but Self Storage, Industrial and Retail are gaining in market share. The current DST market has offerings in over 40 states, so geographic diversification amongst asset classes and sponsors is achievable.

**Information herein was obtained from Mountain Dell Consulting, LLC, an affiliate of Orchard Securities, LLC, Member FINRA/SIPC*

# Real Estate Asset Classes

The commercial real estate market is vast and offers investors numerous entry points for investment. Real estate property types are referred to as "asset classes", which can be divided even further into sub-categories. Understanding the different types of commercial real estate and the risk factors inherent to a particular asset class is important for investors beginning to construct a diversified portfolio of DST investment offerings. Below are the asset classes most typical of the DST investment marketplace.

## Office

Generally, office buildings are used by tenants for professional work, and as a result, the majority are unique to the needs of those tenants who occupy the building. Office buildings vary by use and by business, but the most common is general office use, with primarily technology, banking and professional services tenants under long-term leasing agreements.

The other common use of office buildings is for professional service medical tenants. These properties might have significant tenant improvements to accommodate specialized equipment, medical waste hazards, privacy and patient parking flow; therefore, they may be costly to convert to general office use should a major tenant decide to move out.

Office buildings come in all shapes and sizes, from fifty-story glass and steel towers in San Diego to one-story brick buildings in Oceanside. Height classes are categorized as follows: Low-rise < 7 stories, Mid-rise 7 to 25 stories and High-rise > 25 stories.

There are two location classifications: Central Business District (CBD) and suburban. While you might find the full spectrum of heights in the CBD, lower rents in the suburbs generally do not support the costliest construction techniques that high-rise and even most low-rise buildings require.

## Industrial

Industrial buildings are used by tenants for functions such as manufacturing, research and the inventory and distribution of goods. The three main categories are: Manufacturing, Warehouse and Flex/R&D. Because industrial buildings require acreage, wide building footprints, low density parking with trucking access, industrial assets are rarely located in a CBD. Therefore, it is unusual to distinguish them from anything other than use of the asset.

### Manufacturing

A facility used for the conversion, fabrication and/or assembly of raw materials into products and goods. These properties tend to have less than 20% office space and can be further classified for a heavy or light industrial use.

### Flex/R&D

A facility whose design gives its tenants the ultimate flexibility in their use of the space. Sometimes referred to as tech/flex space, these buildings are an office and industrial hybrid that can have anywhere from 30% to 100% office finishes.

### Warehouse

A facility primarily used for the storage and/or distribution of materials, goods and merchandise. These buildings tend to have less than 15% office space, and modern facilities have high clear ceiling heights that allow for more cubic storage space. This category also may include specialty facilities, such as cold or freezer storage for food and chemicals.

## Retail

Retail property types range from single-tenant buildings such as a Walgreens or Restoration Hardware, to large mega-malls with hundreds of tenants. High rise buildings typically have retail on the ground level floors with office, hospitality and residential on the top floors and referred to as "mixed use". Retail centers which have more than single tenant are grouped by size and tenant type and generally segmented as follows:

### Power Centers

These centers are dominated by tenants commonly referred to as "big box" retailers, such as Dick's Sporting Goods, Walmart and Bass Pro Shops with maybe a few smaller tenants on the property.

### Lifestyle Centers

As enclosed malls became worn and outdated, a new generation of open-air destination and experiential retail centers was developed. These lifestyle center tenants can include upscale apparel and home furnishing retailers, along with dining, entertainment, fitness and playgrounds.

### Neighborhood Centers

These centers include a mix of general merchandise and convenience-oriented tenants. Oftentimes, these centers are "anchored" by a big box retailer such as Target, Walmart or a national grocery chain. These centers might range in size from 30,000 to 400,000 square feet with ample parking for longer customer stays.

### Strip Centers

Named for their inline or straight configurations, these centers typically focus on convenience businesses such as dry cleaners, beauty salons and quick serve restaurants (QSR). Strip centers generally are smaller than 30,000 square feet with high traffic parking lots and a mix of nationally recognized businesses with local "mom and pop" tenants.

### Regional Malls

Regional malls range in size from about 400,000 to 800,000 square feet and might have hundreds of tenants. Parking structures and surface lots support both employees and customers with many having access to public transportation on site as well. On-line shopping has forever changed the regional mall's business model so many are veering towards the tenant mix of the lifestyle centers.

## Self-Storage

Self-storage is an asset class that has evolved in the past decade. The rural and suburban properties with gravel driveways and roll-up metal doors are being consolidated and replaced by modern facilities with sophisticated technology and institutional caliber operators.

Self-storage traditionally was a mom-and-pop operation offering its tenants a means of storing personal goods such as furniture, seasonal and unwanted household items. Today's tenants want climate-controlled facilities for classic cars, wine collections, artwork or the inventory and equipment of their businesses. Properties are often large complexes that are well-maintained and actively managed.

Self-storage properties were typically located on the periphery of metro areas or hidden away in an industrial park. Today's generation of self-storage properties are located closer to their urban area customer base with landscaping and upscale designs to blend in with the surrounding communities. Technology has improved operating efficiencies, reducing staffing needs while enhancing the customer's experience.

Self-storage is unique in the fact that often the owner of the real estate is also the operator of the business which manages the tenants, or those renters of each self-storage unit. Therefore, self-storage places emphasis on the skills of the operator, unlike other asset classes such as retail, where the operator simply needs to maintain the property for a tenant like Walmart so they can best operate their business.

## Senior Housing

Senior housing is a niche sector of the multifamily industry which aims to provide both housing and services to the 55+ age demographic. The aging baby boomer population and its resiliency to occupancy swings during economics cycles has brought senior housing into the mainstream of institutional investing. The main categories of senior housing include independent living, assisted living, skilled nursing and memory care.

Senior properties can be configured as stand-alone or adjoining facilities, as well as campus-style continuing care retirement communities (CCRC). The campus settings offer a tiered approach to the aging process which allows residents to move from one type of facility to another as their level of care needs change. Campus setting are ideal for spouses or family members who want to live in proximity to each other but have different care needs.

### Assisted Living

These facilities are licensed and combine housing with a variety of personal support services and healthcare assistance. These properties seek to attract residents who need extra services related to their medical care, transportation, meals and laundry.

### Memory Care

These long-term care properties serve residents with memory impairment, primarily dementia such Alzheimer's Disease, which makes it unsafe for them to live at home or with family members. Also referred to as special care units (SCU), memory care facilities often provide 24-hour supervision within a separate wing or floor of an assisted living property.

### Skilled Nursing

These properties are generally licensed and provide 24-hour skilled care for chronic and short-term conditions that require more intensive or specialized medical and nursing care. Like memory care, these facilities are often located within a separate wing or floor of an assisted living property.

### Independent Living

These properties are designed for seniors who require little or no assistance living their daily lives. These properties seek to attract residents who are 55+ yeas of age with a variety of on-site amenities and social programming. These properties may offer fine dining and hospitality type services while catering to the active senior with an emphasis on healthy living.

## Multifamily

As an asset class, multifamily spans a wide spectrum of residential properties that technically includes all buildings with at least two housing units where a tenant of the units pays the property owner rent on a regular basis.

The buildings come in all shapes and sizes, from duplexes and high-rises in dense urban areas to resort-style complexes in the suburbs complete with swimming pools and fitness centers all joined by a variety of indoor and outdoor common areas for the tenants. Multifamily is also characterized by shared physical and mechanical systems such as common walls, utilities, parking and amenities.

The industry "grades" multifamily properties as Class A, B or C based on such criteria as age of the building, quality of the construction, the amenities offered to the tenants, rent per square foot and metropolitan area location.

In terms of size classification, multifamily buildings are often categorized as follows: Low-rise or Garden Style < 4 stories, Mid-rise 5 to 9 stories and High-rise > 10 stories.

Generally, 1031 Exchange investors will see three categories of multifamily housing being offered for investment: Apartment, Manufactured or Student Housing all typically within the Class A grade to garner maximum rental income and attract an upscale tenant profile.

## Multifamily (cont.)

### Apartment Complexes

Apartment complexes in suburban locations are often referred to as "garden-style" and fill the gap between walk-up apartment buildings containing up to 40 units, and urban high-rise apartment buildings.

The term garden refers to buildings typically no more than 3 stories tall set in a complex around lawns, wooded areas with picnic, grilling, playground and dog park common areas to mention a few.

The apartment units themselves typically have some outdoor living space, often a ground floor patio or enclosed balconies on the upper floors. Common area amenities might include a fitness center, swimming pool, covered parking, co-working facility and special event rooms for use by residents.

### Student Housing

Student housing is purpose built and characterized as housing principally serving undergraduate or graduate college students. The sector is noted for its dependable cash flows and has benefited from recent demand trends in higher education.

Unique to student housing is that leasing is offered by room or bed, and not an entire unit. This represents the shared nature of the accommodations and allows individual renters to be charged based on their specific bed and share of the applicable common areas.

Leasing terms are typically one-year durations and tied to the school year, which leads to a high annual turnover and a competitive window of time for recruiting the student population, requiring intense marketing by the operator.

Traditional on-campus student housing facilities (think dorms) are often outdated and space constrained, which limits remodeling and leaves them lacking modern amenities. The investment offerings DST investors have access to are private developments which differentiate themselves by better aligning their properties with student needs and parent's safety concerns in locales convenient to campus, sport stadiums and nightlife.

### Manufactured Housing

Manufactured housing communities (commonly thought of as mobile homes located in trailer parks) by definition, are prefabricated housing units largely assembled in factories and professionally transported to its site of use. The units are required to have a permanent chassis to assure continued transportability of the homes.

Manufactured housing communities require limited upkeep by the operator because the tenants own and maintain their housing units. The operator is only responsible for maintaining common area amenities, roads and the utility infrastructure. Therefore, manufactured housing communities have lower operating costs than traditional multifamily real estate.

Manufactured housing is considered the most affordable homeownership option and a unique asset class that addresses the nationwide housing affordability crisis. But there are significant barriers to developing new manufactured housing communities — zoning, entitlements and the required permits for constructing new communities are very difficult for developers to obtain.

As a result of the limited new supply, renovation of existing manufactured housing communities has improved the industry's reputation and quality of the assets dramatically over the years, leading to greater institutional ownership and now a prevalent asset class for DST investors.

# CONTACT

## Tom Straw

In 1994, Tom began his career marketing investment management services to public retirement systems throughout the country working for firms such as Principal Global Investors, Goldman Sachs Asset Management and Golden Tree Asset Management. After leaving Goldman, Tom launched his placement efforts in 2007 to assist independent asset management firms and real estate operators in their pursuit of institutional capital. Tom has also personally entitled and developed single-family residential, multi-family for sale and retail strip in Los Angeles County while advising on real estate development nationwide. Tom is a 1988 graduate of Creighton University in Omaha, NE and lives in Sunrise Beach, TX.

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